III. NOTE ON RESOLUTION TRUST CORPORATION (RTC) AND THE TREATMENT OF "WORKING CAPITAL" OR "BRIDGE" FINANCING

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The Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) created a new Federal agency, the Resolution Trust Corporation (RTC), and provided it with $50 billion to fund the costs of resolving the backlog of insolvent thrift institutions acquired from the defunct FSLIC or new thrift insolvencies expected between August 1989 and August 1992. FIRREA also created the Resolution Funding Corporation (REFCORP), a Government-sponsored enterprise to provide $30 billion to the RTC in 1990 and 1991 to help finance RTC activity. The remaining $20 billion was provided in 1989 as a direct appropriation ($18.8 billion) and a $1.2 billion payment from the Federal Home Loan Banks. The $50 billion provided by FIRREA, together with working capital financing needed to acquire and hold illiquid and other assets from insolvent thrifts, is currently expected to allow the RTC to resolve thrift insolvencies as contemplated in FIRREA.

RTC Net Outlays

Net outlays for the RTC as shown in the 1991 budget reflect the difference between RTC spending to resolve insolvent thrift cases and any offsetting collections, primarily funds raised by the REFCORP, used to finance that spending each year. Annual projections for both RTC spending and REFCORP collections are subject to substantial variations. Current REFCORP collections estimates assume REFCORP bonds will be sold in quarterly offerings averaging $5 billion during 1990 and 1991. Changes in bond market conditions or cash needs of the RTC could alter this assumption.

Even greater variation is possible for RTC spending projections. The RTC plans to move as quickly as possible to resolve the more than 500 thrift institutions it either now has under its control or expects to receive from the Office of Thrift Supervision (OTS). Actual annual spending to cover the net loss associated with case resolutions will depend upon the number of cases resolved each year and the extent of the losses for each case. The timing of case resolutions and the costs or losses projected for each resolution, in turn, depend upon highly uncertain local economic conditions and outstanding legal issues concerning specific thrift assets, the legality of past regulatory actions, and various other legal questions. The Administration's economic forecasts for the budget are national, not region-specific, projections. The importance of regional or local economic conditions, e.g., the health of the Southwest economy, only increases the range of uncertainty surrounding RTC budget outlay projections.

The RTC and the RTC Oversight Board have developed an initial strategic plan for handling thrift insolvency cases. The strategic plan will be updated frequently with RTC implementing guidelines and procedures, and with new Oversight Board policies. The spending projections shown below can be expected to change as the RTC and the Oversight Board refine their current estimates and procedures.

Decisions concerning the amount and timing of working capital needed to purchase and hold illiquid assets could also significantly affect budget outlay projections for the RTC. The working capital issue for the RTC is especially complex and is discussed in more detail below. As explained in the working capital section, RTC budget spending projections exclude extraordinary RTC prospective working capital needs.

As Table III-1 indicates, net budget outlays for the RTC are expected to be $2.3 billion in 1990 and $7.3 billion in 1991. Actual 1989 outlays were $9.1 billion, substantially less than the $18.8 billion estimated in August when FIRREA was enacted. This decline in 1989 outlays was due primarily to delays in resolving a number of thrift cases in late September. Although these cases were resolved in October, this 1989 experience illustrates the substantial degree of uncertainty affecting RTC budget outlay projections.

The 1990 net outlay projections assume that the RTC will spend $26 billion on losses (i.e., to cover the negative net worth "hole") for case resolutions, $15.4 billion to acquire temporarily certain thrift assets, $1.6 billion for advances, and $0.2 billion on administrative costs. In 1991, RTC is projected to spend $20.9 billion for losses on case resolutions, $11 billion for temporary asset acquisition, and another $0.3 billion for administrative expenses.

These total expenditures of $43.2 billion in 1990 and $32.2 billion in 1991 will be offset by the $30 billion in REFCORP bond proceeds ($19.5 billion in 1990 and $10.5 billion in 1991); receipts from the sale of assets (projected to be $12.8 billion for both 1990 and 1991), and repayments of advances made to replace high cost deposits in 1989 and 1990.

Table III-1. **RTC NET OUTLAYS**

(In billions of dollars)

	1989	1990	1991
Offsetting collections	−1.2	−40.9	−24.8
Expenditures	10.3	43.2	32.2
Net outlays	9.1	2.3	7.3

RTC "Working Capital" Financing

FIRREA authorized the RTC to finance "working capital", which is the temporary financing needed to acquire and hold for resale assets from thrift institutions resolved by the RTC. (FIRREA also limited the amount of any Federal working capital or bridge financing to the fair market value of RTC assets to prevent its being used to fund permanent thrift losses.) Ordinarily, budget issues involving bridge financing do not arise in

case resolutions because the temporary holding period is short (sometimes instantaneous) and because the volume of case resolutions is not so large as to have major budgetary impacts. However, the RTC faces extraordinary working capital demands because of the severe illiquidity of many of the assets held by insolvent thrifts, the sheer size of the potential illiquid asset pool, and the need to dispose of assets on an orderly basis. The substantial legal questions involved with many of these assets and the extended period of time required to hold them distinguish the extraordinary working capital problems of the RTC from normal working capital or bridge financing for the temporary acquisition of assets. The RTC's extraordinary working capital needs raise several complex problems, including:

- the substantial uncertainty about both the total need for this type of working capital over the lifetime of the RTC and the estimated requirements in any one fiscal year;
- the alternative sources of financing for this unique form of working capital, ranging from direct Federal funding, to Federally guaranteed or partially guaranteed funding and totally private funding;
- the conceptual budget accounting issues raised by the various financing sources for extraordinary working capital; and
- the perverse fiscal policy and budget deficit effects these alternative working capital assumptions could produce.

Table III-2 illustrates a potential range of working capital needs. The major differences between the "high need" and "low need" estimates are assumptions about when RTC acquires the troubled assets in the institutions under its control, and how quickly it can sell them. Extraordinary working capital needs reflect the shortfall between available receipts from the sale of previously acquired assets and the funds needed to acquire assets in any given time period. The table shows a hypothetical range of $43 billion to $83 billion in working capital needs in 1990-91, when most of the illiquid assets are likely to be acquired. However, over the full 1990-96 period, the net need for extraordinary working capital is zero, as asset sale receipts in the out-years exceed additional asset purchase financing needs.

TABLE III-2. **ILLUSTRATIVE RANGE OF WORKING CAPITAL NEEDS**

(In billions of dollars)

	1990	1991	1992	1993-96	1990-96
Low need (in 1990-91):					
Asset purchases [1] [2]	51	50	40	.....	141
Asset receipts [2]	−12	−46	−44	−39	−141
Shortfall (surplus) [3]	39	4	−3	−39	.....
High need (in 1990-91):					
Asset purchases [1] [2]	67	57	17	.....	141
Asset receipts [2]	−5	−36	−46	−54	−141
Shortfall (surplus) [3]	62	21	−29	−54	.....

[1] Stated at expected recovery (market) values. Losses on assets are financed by funds authorized to cover the negative net worth of RTC cases.
[2] Does not account for 1989 transactions.
[3] Shortfall indicates extraordinary working capital need.

This range of extraordinary working capital needs can have varying effects on RTC budget outlay estimates, depending upon the source of the financing used and the budgetary accounting treatment accorded each source. This additional complexity is particularly problematic because it could lead to potential perverse budget deficit (or surplus) effects without any change in the real economic transactions between the public and the Government. For example, Federal financing of working capital, combined with maximum asset acquisition in 1990, could balloon the 1990 deficit but substantially reduce the 1991 and outyear deficits as the assets acquired in 1990 are sold. The Administration's RTC budget estimates deliberately exclude extraordinary working capital transactions in order to prevent their use to increase 1991 and outyear receipts to meet the GRH deficit targets.

Conceptually, bridge financing is only a means of financing the temporary acquisition and sale of assets. The real economic transaction is the loss resulting from the writedown of acquired assets from their inflated book value to actual market value. This loss is fully accounted for and financed through the appropriations and REFCORP collections that FIRREA provides the RTC.

Normal bridge financing needs—when assets are only held for up to a few months—do not create the same potential budget problem as RTC's extraordinary needs because receipts and disbursements usually occur within the same fiscal year. RTC's extraordinary working capital needs, with its extended holding time, greatly aggravates the blurring of purely financing transactions and expenditure transactions.

Although FIRREA authorizes the RTC to use bridge financing, including direct or Federally guaranteed financing, it is clear that no such issue as this extraordinary working capital need (certainly none at this scale) was explicitly contemplated by the drafters of G-R-H. Under the G-R-H law, the sales of unique assets do not count as receipts for purposes of reducing the G-R-H baseline deficit. In principle, one would think that if the sale of an asset does not count as a receipt, its temporary purchase (for purpose of sale) should not count as an outlay. While intended to prevent unplanned sales of already acquired assets solely to achieve temporary deficit reduction, the G-R-H treatment of asset sale receipts could create a budget presentation anomaly for the RTC. RTC was not created to acquire any of these thrift assets to hold permanently. If, however, the purchase of assets is counted as an outlay, but their sale is not counted as a receipt, then the budget for the RTC over time would reflect a permanent acquisition of assets—a total misrepresentation of the RTC's purpose.

Both the broader conceptual issue of the whipsaw effect on the budget and the current G-R-H treatment of unique or unusual asset sales suggest a case can be made for providing special budgetary treatment of these extraordinary working capital transactions. Clearly, that treatment should not affect sequester calculations, since there is no real economic effect associated with the temporary financing or its accounting. Every dollar of Government funds permanently expended on net losses in the thrift industry—"filling the net worth hole"—should be and is included as an expenditure in the budget. With extraordinary working capital, howev-

er, funds are temporarily raised to acquire assets on an interim basis; the outstanding obligations must be fully collateralized by the assets acquired; and the obligations are fully repaid when the assets are sold. For this and other reasons, the Administration has distinguished between its treatment of net losses and extraordinary working capital in the RTC budget.

This is a matter about which many in Congress have expressed substantial interest. The Administration expects to advise Congress of its working capital proposal within the next several weeks and then begin providing working capital to the RTC. The Administration will also work with Congress to assure that a responsible system of budgetary accounting is developed.